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TO RUEHC/SECSTATE WASHDC 4418  
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RUEHBK/AMEMBASSY BANGKOK 3619  
RUEHBJ/AMEMBASSY BEIJING 6462  
RUEHUL/AMEMBASSY SEOUL 8521  
RUEHGP/AMEMBASSY SINGAPORE 6845  
RUEHKO/AMEMBASSY TOKYO 8562  
RUEHML/AMEMBASSY MANILA 9971  
RUEHJA/AMEMBASSY JAKARTA 4019  
RUEHKL/AMEMBASSY KUALA LUMPUR 3700  
RUEHHI/AMEMBASSY HANOI 3252  
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USTR FOR ALTBACH AND STRATFORD  
USDOC FOR 3132/USFCS/OIO/EAP/WZARIT  
TREASURY FOR OASIA/LMOGHTADER  
TREASURY ALSO PASS TO FEDERAL RESERVE/BOARD OF  
GOVERNORS, NEW YORK FRB/MARA BOLIS AND SAN FRANCISCO FRB/TERESA  
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SUBJECT: Taiwan's 2006 Balance of Payments

11. SUMMARY: Taiwan's current account surplus in 2006 surged nearly 60% to US\$25 billion. The C/A surplus was largely offset by a huge capital outflow of direct investment and insurance firms' portfolio investment. Depreciation of the US Dollar (USD) drove up the USD value of Taiwan's EURO and Yen foreign exchange (FX) reserves. Taiwan's valuation-adjusted FX reserves in 2006 grew by US\$13 billion or 5% to US\$266 billion. In 2007, Taiwan's C/A surplus may be totally offset by net capital outflow due to Taiwan's low interest rates. END SUMMARY.

Favorable Trade Leads Keeps C/A Positive  
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12. Taiwan's current account (C/A) has enjoyed surpluses every year since 1981. Its C/A surplus in 2006 surged nearly 60% to US\$25 billion from US\$16 billion in 2005. Over 90% of the C/A surplus or US\$23 billion came from merchandise trade, boosted by double-digit growth in exports to developed markets as well as shipments of production inputs to China and Southeast Asia, where many Taiwan manufacturing firms have located their export manufacturing.

Deep Cut in Service Trade Deficit  
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13. Two other sources of the C/A surplus were (1) triangle trade and (2) interest earned from Taiwan's FX reserves. Triangle trade (i.e., orders placed in Taiwan and shipped from overseas production bases) began to play an important role in Taiwan's service trade in the mid-1990s as a growing number of manufacturing firms began to relocate their factories overseas, particularly in the PRC. Income generated from triangle trade in 2006 increased to US\$14.9 billion or 6.7% of total merchandise exports, leading to a 37% cut in Taiwan's service trade deficit from US\$6.6 billion in 2005 to US\$4.2 billion in 2006.

## TBC Contributes to Factor Income's Inflow

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14. Taiwan's FX reserves, ranking third largest in the world, have brought huge interest earnings which reversed the factor income account from a chronic net outflow to a chronic net inflow in 1982. In 2006, the US Federal Reserve Banks steadily raised interest rates; together with Taiwan Central Bank's (TCB) effective management of its FX assets, this contributed to a 20% growth in interest earned from Taiwan's FX reserves to US\$14.7 billion and 20% growth in the factor income account's inflow to US\$20 billion in 2006.

## Capital Outflow

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15. Capital outflow caused Taiwan's financial account (F/A) have a deficit of US\$23 billion in 2006, down from a surplus of US\$1.7 billion in 2005. Capital left Taiwan mainly in the form of foreign direct investment (FDI) and portfolio investment (PI). Total outbound FDI and PI in 2006 increased 26% to US\$51.4 billion, which was US\$22 billion more than the inbound total.

## China Accounts for Majority of Taiwan FDI

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16. In 2006, outbound FDI increased 21% to US\$7.3 billion, a majority of which went to China. The TCB's FDI statistics are not organized by country, but approval figures compiled by the Ministry of Economic Affairs (MOEA) are organized by country. FDI approved in 2006 totaled US\$11.9 billion. Of this amount, 80% went to China, including 64% directly to China and 16% (according to Investment

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Commission estimates) indirectly to China through such third territories as Caribbean tax havens. The combined share of approved FDI going directly and indirectly to China exceeded 85% in 2005.

## Low Interest Rate Drives up Outbound PI

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17. While openness of Taiwan's stock market has attracted many foreign portfolio investors, low interest rates are driving local funds to seek higher yields in overseas financial markets. Taiwan's interest rates are among the lowest in the world. The interest rate gap between Taiwan and the United States broadened from less than half a percentage point in 2004 to above 3 percentage points in 2006. The interest rate gap has brought heavy pressure on Taiwan insurance companies which have to meet high-yield commitments made to policy owners. Consequently, overseas stocks and bonds bought by Taiwan insurance firms steadily increased from US\$22.6 billion in 2004 and US\$31 billion in 2005 to US\$42.5 billion in 2006. In 2006, insurance firms accounted for 86% of Taiwan's total outbound PI.

## Increase in FX Assets

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18. The FX reserves held by the TCB (before valuation adjustment) increased US\$6.1 billion. However, valuation adjustment of the EURO and Japanese Yen reserves drove up the increase to US\$12.9 billion. Taiwan's FX reserves grew in 2006 to US\$266 billion, about 30% of which are in the Euro and Japanese yen. In 2006, the EURO and the Japanese Yen appreciated 11% and 13.6% against the USD, respectively.

## Prospects

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19. Taiwan's current account will continue in surplus in 2007 as Taiwan remains an export-oriented economy and a production input supplier to the many Taiwan firms located in China and Southeast Asian nations. However, Taiwan's FX reserves may level off or even decline in 2007 and beyond as the current account surplus may be totally offset by a financial account deficit if the TCB continues to keep local interest rates far below levels in the United States

and Europe. The interest rate gap will force insurance firms and other Taiwan portfolio investors to seek portfolio investment opportunities overseas.

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